purposes of the preceding sentence, the rules of § 1.861–8 shall apply (with creditable expenditures treated in the same manner as deductible expenditures).

(d) *Definitions.* For purposes of this section:

(1) The rules of § 1.937–1T shall apply for determining whether an individual is a bona fide resident of Puerto Rico.

(2) The rules of § 1.937–2T shall apply for determining whether income is from sources within Puerto Rico.

(e) *Effective date.* This section shall apply for taxable years ending after October 22, 2004.

[T.D. 9194, 70 FR 18934, Apr. 11, 2005, as amended by T.D. 9248, 71 FR 5001, Jan. 31, 2006]

§ 1.934–1 Limitation on reduction in income tax liability incurred to the Virgin Islands.

[Reserved]. For further guidance, see § 1.934–1T.

[T.D. 9194, 70 FR 18935, Apr. 11, 2005]

§ 1.934–1T Limitation on reduction in income tax liability incurred to the Virgin Islands (temporary).

(a) *General rule.* Section 934(a) provides that tax liability incurred to the United States Virgin Islands (Virgin Islands) shall not be reduced or remitted in any way, directly or indirectly, whether by grant, subsidy, or other similar payment, by any law enacted in the Virgin Islands, except to the extent provided in section 934(b). For purposes of the preceding sentence, the term ''tax liability'' means the liability incurred to the Virgin Islands pursuant to subtitle A of the Internal Revenue Code, as made applicable in the Virgin Islands by the Act of July 12, 1921 (48 U.S.C. 1397), or pursuant to section 28(a) of the Revised Organic Act of the Virgin Islands (48 U.S.C. 1642), as modified by section 7651(5)(B).

(b) *Exception for V.I. income*—(1) *In general.* Section 934(b)(1) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands to the extent that such tax liability is attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands.

(2) *Limitation.* Section 934(b)(2) limits the scope of the exception provided by section 934(b)(1). Pursuant to this limitation, the exception does not apply with respect to an individual who is a citizen or resident of the United States (other than a bona fide resident of the Virgin Islands). For the rules for determining tax liability incurred to the Virgin Islands by such an individual, see section 932(a) and the regulations thereunder.

(3) *Computation rule*—(i) *Operative rule.* For purposes of section 934(b)(1) and this paragraph (b), tax liability incurred to the Virgin Islands for the taxable year attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands shall be computed as follows:

(A) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under mirrored section 901(a);

(B) Multiply by taxable income from sources within the Virgin Islands and income effectively connected with the conduct of a trade or business within the Virgin Islands (applying the rules of § 1.861–8 to determine deductions allocable to such income);

(C) Divide by total taxable income; and

(D) Subtract the portion of any credit allowed under mirrored section 901 (other than credits for taxes paid to the United States) determined by multiplying the amount of taxable income from sources outside the Virgin Islands or the United States that is effectively connected to the conduct of a trade or business in the Virgin Islands divided by the total amount of taxable income from such sources.

(ii) *Limitation.* Tax liability incurred to the Virgin Islands attributable to income derived from sources within the Virgin Islands or income effectively connected with the conduct of a trade or business within the Virgin Islands, as computed in this paragraph (b)(3), however, shall not exceed the total amount of income tax liability actually incurred.

(4) *Definitions.* For purposes of this section:

(i) *Bona fide resident.* The rules of §1.937–1T shall apply for determining whether an individual is a bona fide resident of the Virgin Islands.

(ii) *Source.* The rules of §1.937–2T shall apply for determining whether income is from sources within the Virgin Islands.

(iii) *Effectively connected income.* The rules of §1.937–3T shall apply for determining whether income is effectively connected with the conduct of a trade or business in the Virgin Islands.

(c) *Exception for qualified foreign corporations*—(1) *In general.* Section 934(b)(3) provides an exception to the application of section 934(a). Under this exception, section 934(a) does not apply with respect to tax liability incurred to the Virgin Islands by a qualified foreign corporation to the extent that such tax liability is attributable to income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States.

(2) *Qualified foreign corporation.* For purposes of paragraph (c)(1) of this section, the term *qualified foreign corporation* means any foreign corporation if 1 or more United States persons own or are treated as owning (within the meaning of section 958) less than 10 percent of—

(i) The total voting power of the stock of such corporation; and

(ii) The total value of the stock of such corporation,

(3) *Computation rule*—(i) *Operative rule.* For purposes of section 934(b)(3) and this paragraph (c), tax liability incurred to the Virgin Islands for the taxable year attributable to income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States shall be computed as follows—

(A) Add to the income tax liability incurred to the Virgin Islands any credit against the tax allowed under mirrored section 901(a);

(B) Multiply by taxable income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States (applying the rules of §1.861–8 to determine deductions allocable to such income);

(C) Divide by total taxable income; and

(D) Subtract any credit allowed under mirrored section 901 (other than credits for taxes paid to the United States or taxes for which a credit is allowable for U.S. Federal income tax purposes under section 906 of the Internal Revenue Code).

(ii) *Limitation* Tax liability incurred to the Virgin Islands attributable to income which is derived from sources outside the United States and which is not effectively connected with the conduct of a trade or business within the United States, as computed in this paragraph (c)(3), however, shall not exceed the total amount of income tax liability actually incurred.

(4) *U.S. income*—(i) *In general.* For purposes of this section, except as provided in paragraph (c)(4)(ii) of this section, the rules of sections 861 through 865 and the regulations thereunder shall apply for determining whether income is from sources outside the United States or effectively connected with the conduct of a trade or business within the United States.

(ii) *Conduit arrangements.* Income shall be considered to be from sources within the United States for purposes of paragraph (c)(1) of this section if, pursuant to a plan or arrangement—

(A) The income is received in exchange for consideration provided to another person; and

(B) Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.

(d) *Examples.* The rules of this section are illustrated by the following examples:

Example 1. (i) S is a U.S. citizen and a bona fide resident of the U.S. Virgin Islands (USVI). For 2005, S files a Form 1040INFO, ''Non-Virgin Islands Source Income of Virgin Islands Residents,'' with the USVI on which S reports total gross income as follows:

Compensation for services performed in the USVI	$50,000
Compensation for services performed in the United States	40,000
Compensation for services performed in Mexico	30,000

Income from inventory sales in Latin America attributable to USVI Office	20,000
Interest on a U.S. bank account	6,000
Interest on a V.I. bank account	5,000
Dividends from a U.S. corporation	4,000

(ii) Accordingly, S has total gross income of $155,000, comprising income from sources within the USVI or effectively connected to the conduct of a trade or business in the USVI (USVI ECI) of $75,000, income from sources within the United States of $50,000, and income from other sources (not USVI ECI) of $30,000. After taking into account allowable deductions, S's total taxable income is $120,000, of which $45,000 is taxable income from sources within the USVI, $15,000 is taxable income from other sources that is USVI ECI under the rules of section 937(b) and §§1.937–2T and 1.937–3T, and $22,500 is taxable income from sources outside the USVI (and outside the United States) that is not USVI ECI. S's tax liability incurred to the USVI pursuant to the Internal Revenue Code as applicable in the USVI (mirror code) is $30,000. S is entitled to claim a credit under section 901 of the mirror code in the amount of $10,000 for income tax paid to Mexico and other Latin American countries, for a net income tax liability of $20,000.

(iii) Pursuant to a USVI law that was duly enacted within the limits of its authority under section 934, S may claim a special deduction relating to his business activities in the USVI. However, under section 934(b), S's ability to claim this special deduction is limited. Specifically, the maximum amount of the reduction in S's mirror code tax liability that may result from claiming this deduction, computed in accordance with paragraph (b)(3) of this section, is as follows:

$(20{,}000 + 10{,}000) \times ((45{,}000 + 15{,}000) / (120{,}000)) - 10{,}000 \times ((15{,}000) / (15{,}000 + 22{,}500)) = 30{,}000 \times (.5) - 10{,}000 \times (.4) = 15{,}000$ minus; $4{,}000 = \$11{,}000$

(iv) Accordingly, S's net tax liability incurred to the USVI must be at least $19,000 (30,000 − 11,000), prior to taking into account any foreign tax credit.

Example 2. The facts are the same as *Example 1,* except that S is a U.S. citizen who resides in the United States. As required by section 932(a) and (b), S files with the U.S. Virgin Islands (USVI) a copy of his Federal income tax return and pays to the USVI the portion of his Federal income tax liability that his Virgin Islands adjusted gross income bears to his adjusted gross income. Under section 934(b)(2), S may not claim the special deduction offered under USVI law relating to business activities like his in the USVI to reduce any of his tax liability payable to the USVI under section 932(b).

Example 3. (i) Z is a nonresident alien who resides in Country FC. In 2005, Z receives dividends from a corporation organized under the law of the U.S. Virgin Islands (USVI) in the amount of $90x. Z's tax liability incurred to the USVI pursuant to section 871(a) of the Internal Revenue Code as applicable in the USVI (mirror code) is $27x.

(ii) Pursuant to a USVI law that was duly enacted within the limits of its authority under section 934, Z may claim a special exemption for income relating to his investment in the USVI. The maximum amount of the reduction in Z's mirror code tax liability that may result from claiming this exemption, computed in accordance with paragraph (b)(3) of this section, is as follows:

$27x\ (90x/90x) = \$27x$

(iii) Accordingly, depending on the terms of the exemption as provided under USVI law, Z's net tax liability incurred to the USVI may be reduced or eliminated entirely.

Example 4. (i) A Corp is organized under the laws of the U.S. Virgin Islands (USVI) and is engaged in a trade or business in the United States through an office in State N. All of A Corp's outstanding stock is owned by U.S. citizens who are bona fide residents of the USVI. During 2005, A Corp had $50x in gross income from sources within the USVI (as determined under section 937(b) and §1.937–2T) that is not effectively connected with the conduct of a trade or business in the United States; $20x in gross income from sources in Country H that is effectively connected with the conduct of A Corp's trade or business in the United States; and $10x in gross income from sources in Country R that is not effectively connected with the conduct of A Corp's trade or business in the United States.

(ii) Section 934(b)(3) permits the USVI to reduce or remit the income tax liability of a *qualified foreign corporation* arising under the Internal Revenue Code as applicable in the USVI (mirror code) with respect to income that is derived from sources outside the United States and that is not effectively connected with the conduct of a trade or business in the United States. A foreign corporation constitutes a ''qualified foreign corporation'' under section 934(b)(3)(B) if less than 10 percent of the total voting power and value of the stock of the corporation is owned or treated as owned (within the meaning of section 958) by one or more United States persons. A U.S. citizen is a *United States person* as defined in section 7701(a)(30)(A). Given that 10 percent or more of the voting power and value of its stock is owned by U.S. citizens, A Corp does not constitute a ''qualified foreign corporation'' under section 934(b)(3)(B). Accordingly, the USVI may only reduce or remit A Corp's mirror code income tax liability with respect to its $50x in gross income from sources within the USVI.

Example 5. (i) The facts are the same as in *Example 4,* except that the outstanding stock of A Corp is owned by the following individuals:

U.S. citizens who are bona fide residents of the USVI	5%
U.S. citizens who are not bona fide residents of the USVI	3%
Nonresident aliens who are bona fide residents of the USVI	42%
Nonresident aliens who are not bona fide residents of the USVI	50%

(ii) Given that less than 10 percent of the voting power and value of its stock is owned by United States persons, A Corp constitutes a *qualified foreign corporation* under section 934(b)(3)(B). Accordingly, the USVI may reduce or remit A Corp's mirror code income tax liability with respect to its $50x in gross income from sources within the USVI and its $10x in gross income from sources in Country R that is not effectively connected with the conduct of A Corp's trade or business in the United States. In no event, however, may the USVI reduce or remit A Corp's mirror code income tax liability with respect to its $20x in gross income from sources in Country H that is effectively connected with the conduct of A Corp's trade or business in the United States.

(e) *Effective date.* Except as otherwise provided in this paragraph (e), this section applies for taxable years ending after October 22, 2004. Paragraph (c)(4)(ii) of this section applies to amounts paid or accrued after April 11, 2005.

[T.D. 9194, 70 FR 18935, Apr. 11, 2005; 70 FR 32490, June 3, 2005]

§ 1.935–1 Coordination of individual income taxes with Guam and the Northern Mariana Islands.

(a)(1) through (a)(3) [Reserved]. For further guidance, see § 1.935–1T(a)(1) through (a)(3).

(b)(1) [Reserved]. For further guidance, see § 1.935–1T(b)(1).

(2) *Joint returns.* In the case of married persons, if one or both spouses is an individual described in paragraph (a)(2) of this section and they file a joint return of income tax, the spouses shall file their joint return with, and pay the tax due on such return to, the jurisdiction where the spouse who has the greater adjusted gross income for the taxable year would be required under subparagraph (1) of this paragraph to file his return if separate returns were filed. For this purpose, adjusted gross income of each spouse is determined under section 62 and the regulations thereunder but without regard to community property laws; and, if one of the spouses dies, the taxable year of the surviving spouse shall be treated as ending on the date of such death.

(b)(3) [Reserved]. For further guidance, see § 1.935–1T(b)(3).

(4) *Tax accounting standards.* A taxpayer who has filed his return with one of the jurisdictions named in subparagraph (1) of this paragraph for a prior taxable year and is required to file his return for a later taxable year with the other such jurisdiction may not, for such later taxable year, change his accounting period, method of accounting, or any election to which he is bound with respect to his reporting of taxable income to the first jurisdiction unless he obtains the consent of the second jurisdiction to make such change. However, such change will not be effective for returns filed thereafter with the first jurisdiction unless before such later date of filing he also obtains the consent of the first jurisdiction to make such change. Any request for consent to make a change pursuant to this subparagraph must be made to the office where the return is required to be filed under subparagraph (3) of this paragraph and in sufficient time to permit a copy of the consent to be attached to the return for the taxable year.

(b)(5) through (b)(7) [Reserved]. For further guidance, see § 1.935–1T(b)(5) through (b)(7).

(c) through (f) [Reserved]. For further guidance, see § 1.935–1T(c) through (f).

(g) [Reserved]. For further guidance, see § 1.935–1T(g).

(Secs. 7805 (68A Stat. 917; 26 U.S.C. 7805) and 7654(e) (86 Stat. 1496; 26 U.S.C. 7654 (e)) of the Internal Revenue Code of 1954)

[T.D. 7385, 40 FR 50261, Oct. 29, 1975, as amended by T.D. 9194, 70 FR 18937, Apr. 11, 2005]

§ 1.935–1T Coordination of individual income taxes with Guam and the Northern Mariana Islands (temporary).

(a) *Application of section*—(1) *Scope.* Section 935 and this section set forth the special rules relating to the filing of income tax returns, income tax liabilities, and estimated income tax of individuals described in paragraph (a)(2) of this section. Paragraph (e) of this section also provides special rules